

## Message Text

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ACTION EUR-12

INFO OCT-01 ISO-00 EURE-00 SSO-00 NSCE-00 INRE-00 XMB-02

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CIEP-01 LAB-04 SIL-01 OMB-01 ERDA-05 DODE-00 FEAE-00

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TO SECSTATE WASH DC IMMEDIATE 5998

LIMITED OFFICIAL USE SECTION 01 OF 03 OECD PARIS 06706

PASS TREAS FOR PARSKY AND WIDMAN, EB/IFD/OMA FOR RYAN

E.O.11652: N/A

TAGS: EFIN, OECD, EINV, ENRG

SUBJECT: PAPERS FOR IEA AD HOC GROUP ON FINANCIAL AND

INVESTMENT ISSUES (FII); PART II(F) (PAPER ON:

IS INFLATION THE RESPONSIBILITY OF

INDUSTRIALISED COUNTRIES?)

REFS: (A) OECD PARIS 5996

(B) OECD PARIS 5872

(C) STATE 55605

1. MISSION HAS BEGUN RECEIVING FROM SECRETARIAT PRELIMINARY DRAFTS OF "COMMENT OR POSITION" PAPERS, IN ACCORDANCE WITH ASSIGNMENT OF RESPONSIBILITIES MADE AT LAST MEETING OF IEA GOVERNING BOARD AND OF AD HOC GROUP ON  
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FINANCIAL AND INVESTMENT ISSUES ON MARCH 6 (REFTEL A).

INDIVIDUAL POSITION PAPERS WILL BE TRANSMITTED BY  
SEPARATE CABLES .

2. THIS CABLE TRANSMITS THE FOLLOWING PAPER ENTITLED,  
"IS INFLATION THE RESPONSIBILITY OF INDUSTRIALISED  
COUNTRIES?" WHICH CORRESPONDS TO ITEM II(F) OF THE TABLE  
CONTAINED IN DOCUMENT IEA/SPC(75)7 SECOND REVISION,  
CITED IN REFTEL A.

BEGIN TEXT

II(F) IS INFLATION THE RESPONSIBILITY OF INDUSTRIALISED  
COUNTRIES?

1. SINCE THE INDUSTRIAL COUNTRIES ACCOUNT FOR A MAJOR  
PART OF WORLD DEMAND, OUTPUT AND TRADE, AND THEIR  
CURRENCIES ARE ALMOST EXCLUSIVELY USED FOR INTERNA-  
TIONAL TRANSACTIONS, THEY HAVE A MAJOR RESPONSIBILITY  
IN MAINTAINING A REASONABLE DEGREE OF PRICE STABILITY  
IN THE WORLD ECONOMY. THEY ARE FAR FROM HAVING, HOW-  
EVER, FULL CONTROL OVER ALL COSTS AND NOTABLY PRICES OF  
GOODS IMPORTED FROM THIRD COUNTRIES.

2. THE DEMAND MANAGEMENT POLICIES OF THE INDUSTRIAL  
COUNTRIES AS A GROUP FAILED TO CONTAIN THE ACCELERATION  
OF INFLATION FROM 1972 ONWARDS. THE MONETARY UNCER-  
TAINITIES CONTRIBUTED TO AN INCREASINGLY RAPID TRANS-  
MISSION OF INFLATIONARY PRESSURES FROM ONE COUNTRY TO  
ANOTHER. THESE DEVELOPMENTS WERE AGRAVATED BY A SERIES  
OF CROP FAILURES (MAINLY OUTSIDE THE OECD AREA) WHICH  
GAVE A BIG PUSH TO FOOD PRICES AND EVENTUALLY ADDED  
TO WAGE COSTS IN INDUSTRIAL COUNTRIES THEMSELVES.  
FINALLY, THE 1973 BOOM IN NON-FOOD COMMODITY PRICES  
APPEARS TO HAVE RESULTED BOTH FROM THE SYNCHRONISED  
UPSURGE OF DEMAND IN THE OECD AREA AND THE INADEQUATE  
LEVEL OF USERS STOCKS AND SPARE CAPACITY IN MANY  
PRIMARY INDUSTRIES.

3. THE INFLATIONARY IMPACT OF THE OIL PRICE INCREASES  
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WAS SUPERIMPOSED ON THIS ALREADY UNSTABLE SITUATION AND,  
BECAUSE OF THAT INSTABILITY, WENT FAR BEYOND WHAT  
COULD HAVE BEEN EXPECTED UNDER MORE NORMAL CIRCUMSTANCES.  
THE RISE IN PRICE OF NET IMPORTS OF OIL INTO THE OECD  
AREA CORRESPONDED TO SOME 1.5 PERCENT OF TOTAL DOMESTIC  
EXPENDITURE IN 1974 (ON TOP OF ABOUT 0.3 PERCENT IN  
1973). THIS FREQUENTLY-QUOTED FIGURE MAY NOT AT FIRST  
GLANCE SEEM AN ENORMOUS ORDER OF MAGNITUDE GIVEN THE

FACT THAT, ON AVERAGE, CONSUMER PRICES ROSE BY SOME  
14 PERCENT IN 1974. BUT THE OIL SUPPLY LIMITATIONS OF  
LATE 1973 AND EARLY 1974 AND THE RESULTING THREAT OF

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SHORTAGES, FOLLOWED BY THE NEED TO REDUCE THE IMPORT  
BILL WHEN THE COST OF OIL IMPORTS WAS QUADRUPLED,  
PROMPTED GOVERNMENTS TO RELY HEAVILY ON THE PRICE  
MECHANISM TO REDUCE DEPENDENCE ON OUTSIDE SOURCES OF  
ENERGY. TO VARYING DEGREES GOVERNMENTS PERMITTED  
PRODUCER PRICES OF DOMESTIC ENERGY TO RISE IN LINE  
WITH THE COST OF IMPORTED OIL AND GAS, AND THEY ADJUSTED  
THEIR EXPORT PRICES OF ENERGY FULLY TO WORLD PRICES.  
IN ADDITION, SEVERAL GOVERNMENTS INCREASED INDIRECT  
TAXES ON ENERGY. IF THESE FACTORS ARE TAKEN INTO

ACCOUNT, THE IMPACT OF THE ENERGY PRICE INCREASE ON THE OVERALL OECD PRICE LEVEL MAY BE ESTIMATED AT SOME 3.5 PERCENT, RATHER THAN THE 1.5 PERCENT INDICATED ABOVE. ON THIS BASIS, MORE THAN HALF OF THE ACCELERATION OF OECD'S CONSUMER PRICE RISE IN 1974 (TO 14 PERCENT COM-  
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PARSED WITH 8 PERCENT IN 1973) CAN BE ADDUCED DIRECTLY TO THE HIGHER PRICES OF ENERGY. HAD SOME COUNTRIES WITH LARGE DOMESTIC ENERGY PRODUCTION (AUSTRALIA, CANADA AND THE UNITED STATES) NOT DEFERRED THE FULL ADJUSTMENT OF DOMESTIC PRODUCER PRICES TO THE COST OF OIL IMPORTS, ANOTHER 1/2 PERCENT WOULD HAVE BEEN ADDED TO THE OVERALL OECD INFLATION RATE IN 1974.

4. THE PARTICULAR TIMING OF THE OIL PRICE-RISE WAS MOST UNFORTUNATE FROM THE POINT OF VIEW OF THE INFLATION IN THE INDUSTRIALIZED ECONOMIES. IT CAME AT A PERIOD WHEN, FOR MANY MONTHS, OVERALL DEMAND PRESSURES VIRTUALLY THROUGHOUT THE INDUSTRIALISED WORLD HAD BEEN SO STRONG AS TO LEAD TO RECURRENT SHORTAGES AND STRONG INFLATIONARY EXPECTATIONS. THIS ENABLED FIRMS TO PASS THEIR ENERGY-RELATED COST INCREASES FULLY ON INTO SALES PRICES AND - FREQUENTLY - TO ENLARGE THEIR GROSS PROFIT MARGINS AT THE SAME TIME. HAD IT BEEN IMPOSED IN A PERIOD OF WEAK OVERALL DEMAND THERE WOULD HAVE BEEN MORE CHANCE OF CONTAINING THE SPILLOVER EFFECTS - INDEED, FIRMS WOULD HAVE BEEN COMPELLED TO ABSORB PART OF THE ENERGY-RELATED COST INCREASES. THE OIL CRISIS OCCURRED JUST WHEN THERE HAD SEEMED TO BE SIGNS OF AN END TO THE COMMODITY PRICE SURGE. THE QUADRUPLING IN OIL PRICES GAVE THE COMMODITY BOOM A NEW LEASE OF LIFE. TO THESE EFFECTS CAN BE ADDED THE FACT THAT THE UNEXPECTED ACCELERATION OF INFLATION CAUSED BY THE OIL PRICE-RISE GAVE IMPETUS TO A NEW WAGE-PRICE SPIRAL BY REDUCING REAL WAGE EARNINGS AND TRIGGERING ATTEMPTS TO RECOUP THE LOSSES THROUGH HIGHER MONEY WAGES.

5. IN THE PRESENT SITUATION - AND CONTRARY TO THAT PREVAILING UNTIL THE EARLY 1970S - EVEN RELATIVELY SMALL CHANGES IN THE LEVEL OF CRUDE OIL PRICES PLAY A CRUCIAL ROLE IN THE INFLATIONARY PROCESS IN THE INDUSTRIAL COUNTRIES. THIS IS THE CASE FOR TWO REASONS. FIRST, AT END-1974 PRICES THE C.I.F. VALUE OF CRUDE OIL IMPORTS CORRESPONDS TO SOME 2-1/2 PERCENT OF THE TOTAL DOMESTIC EXPENDITURE OF THE OECD AREA AS COMPARED WITH 0.7 PERCENT FIVE YEARS AGO. THIS MEANS THAT FOR EACH 10 PERCENT CHANGE IN THE CRUDE OIL PRICE, THE MECHANICAL IMPACT ON  
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OECD PRICE LEVELS WOULD BE OF THE ORDER OF 1/4 PERCENT. SINCE, HOWEVER, IT IS PRACTICALLY IMPOSSIBLE IN THE LONG-RUN TO MAINTAIN A DIFFERENT PRICE LEVEL FOR DOMESTICALLY PRODUCED SOURCES OF PRIMARY ENERGY, ANOTHER 1/4 PERCENT WOULD HAVE TO BE ADDED ON THIS ACCOUNT. A CONSERVATIVE ESTIMATE OF THE DOMESTIC PRICE MULTIPLIERS UNDER NORMAL DEMAND CONDITIONS WOULD PUSH UP THE TOTAL

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DIRECT AND INDIRECT PRICE EFFECT TO ABOUT 1 PERCENT FOR EACH 10 PERCENT CHANGE IN THE CRUDE OIL PRICE. IN THE SECOND PLACE, SINCE A 1 PERCENT CHANGE IN CRUDE OIL PRICES WOULD INCREASE OR DECREASE BY SOME \$1

BILLION THE OVERALL CURRENT ACCOUNT DEFICIT OF THE OECD  
AREA (\$33 BILLION IN 1974), BALANCE OF PAY-  
MENTS CONSIDERATIONS WILL CONTINUE TO PLAY A MAJOR ROLE  
IN DETERMINING THE ENERGY PRICING POLICIES OF OIL  
IMPORTING COUNTRIES. IN PARTICULAR, THE DEFICI-  
COUNTRIES MUST END THEIR SHORT-TERM

USERS AT ANY GIVEN LEVEL OF IMPORT PRICES.

6. THE INCREASED IMPORTANCE OF THE PRICE OF IMPORTED  
INPUTS, AND NOTABLY CRUDE OIL, SHOULD NOT DETRACT FROM  
THE MORE FUNDAMENTAL RESPONSIBILITY OF THE INDUSTRIAL  
COUNTRIES IN ADOPTING A WHOLE RANGE OF POLICIES - MONE-  
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TARY, FISCAL, INDUSTRIAL, MANPOWER AND TRADE -- CONDCCIE  
TO A MARKEDLY BETTER PRICE PERFORMANCE THAN IN THE YEARS  
IMMEDIATELY PRECEDING THE OIL CRISIS.

7. IN A SOMEWHAT LONGER-TERM CONTEXT, THE RESPONSIBIL-  
ITY OF INDUSTRIAL AND OIL EXPORTING COUNTRIES IN IMPROV-  
ING WORLD PRICE STABILITY GOES WELL BEYOND DEMAND MANAGE-  
MENT ON THE ONE HAND AND OIL PRICING ON THE OTHER. THERE  
IS A NEED FOR CO-OPERATIVE EFFORTS TO IMPROVE THE WORLD  
FOOD SUPPLY AND ENSURE A STEADY EXPANSION OF SUPPLIES OF  
OTHER BASIC MATERIALS. TO THIS EFFECT AN INCREASED  
DEGREE OF CO-OPERATION WILL BE NEEDED TO MAINTAIN ADE-  
QUATE INVESTMENT IN THESE SECTORS. THIS MAY REQUIRE  
BOTH EFFORTS TO STABILISE COMMODITY PRICES AND A STEP-UP  
IN THE TRANSFER OF TECHNOLOGY.

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## Message Attributes

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**Decaption Date:** 01 JAN 1960  
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**Disposition Approved on Date:**  
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